BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
JOHN D. **AND LUCILE A. LINDSEY,**)
AND DEV-LAND, INC.)

Appearances:

For Appellants: Jack H. Olive
Attorney at Law

For Respondent: David M. Hinman
Counsel

O P I N I O N

These appeals are made pursuant to sections 18594 and 25667 of the Revenue and Taxation Code against the action of the Franchise Tax Board on the protest of John D. and Lucile A. Lindsey and Dev-Land, Inc., against proposed assessments of additional personal income tax and franchise tax, as follows:

Appellants	Income Years	Proposed Assessments
John D. Lindsey	1966	$ 2,893.96
	1967	12,387.10
John D. and Lucile A. Lindsey	1968	24,156.90
Dev-Land, Inc.	7/31/77 7/31/66	7,623.31 6,845.77
	7/31/78	5,154.08

Appellant John D. Lindsey (Lindsey) was engaged in recreational land sales as an individual and through Dev-Land, Inc. (Dev-Land), his wholly owned corporation. Dev-Land acted as broker for Lindsey during the appeal years and also sold some of its own parcels of land as principal. Approximately one-half of Dev-Land's sales were of land owned by Lindsey. These sales were usually handled as follows:

The buyer paid ten to twenty-five percent of the purchase price in cash; the balance, secured by a deed of trust, was payable in monthly installments. Fifty-five percent of the down payment went to Dev-Land in partial payment of its commission, which was thirty percent of the sale price; Lindsey received the balance of the down payment. Upon receipt of each installment, Lindsey paid to Dev-Land forty percent of the installment on account of the unpaid portion of the brokerage commission. (The reporting of income from the cash down payment and the monthly installments are not at issue in this appeal.) At two month intervals, Dev-Land had the right to obtain buyers' notes from Lindsey in the amount of the remaining unpaid commissions. No notes were transferred by Lindsey to Dev-Land during the appeal years but notes in the amount of commissions remaining unpaid were transferred in 1969.

Lindsey elected to use the accrual method of accounting and to report his income from land sales using the installment method. He reported as income his share of each payment as it was received. However, he deducted the entire commission expense payable to Dev-Land in the year of sale.

Dev-Land also elected the accrual method of accounting. It reported each commission payment when it was received from Lindsey. If a buyer defaulted on a note, then Lindsey was not obligated to continue paying Dev-Land the commission on the sale. When notes transferred from Lindsey were the mode of payment, Dev-Land reported only 25 percent of the face value of the notes upon receipt, and as payments were made on the notes, Dev-Land reported 75 percent as taxable income and 25 percent as a return of capital.

After auditing appellants' returns for the years in question, respondent disallowed all the commissions expense claimed by Lindsey, except that which he was required to pay Dev-Land from buyers' installment payments. This action was based on respondent's determination that the commission expense did not accrue until each installment was received from the buyer, at which time Lindsey's liability to pay Dev-Land was fixed.

Because the taxpayers are related and both use the accrual method of accounting, respondent believed that appellants' accounting of the commissions as income and expense should be consistent, that is, accrue simultaneously. Lindsey disagreed, maintaining that the full commissions expense was deductible by him in the year of sale. Thereafter, respondent's auditor issued assessments against Dev-Land, applying Lindsey's accounting method on the theory that if Lindsey properly deducted the entire commissions expense, then Dev-Land should have reported the entire amount as income in the same year, in order to clearly'reflect both appellants' income.

Respondent and appellants failed, in several meetings, to agree on an accounting method for both taxpayers, Appellants maintain that the issue of an accounting method is secondary to the question of whether Dev-Land properly discounted the face value of notes it received. At the oral hearing in this matter, appellants presented testimony concerning the fair market value of recreational land sales notes and respondent's counsel conceded that a forty to fifty percent valuation was reasonable. However, he emphasized that the primary issue remained the consistent timing of income and deductions by the taxpayers.

For the reasons expressed below, we have concluded that Lindsey improperly deducted the entire commissions expense at the time of sale.

It is well established that the method of accounting used by a taxpayer must clearly reflect income. (Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(2).) If a taxpayer chooses the accrual method then he may claim deductions for the taxable year "in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." (Cal. Admin. Code, tit. 18, reg. 17591, subd. (a)(2).)

Under the terms of Lindsey's contract with Dev-Land, Lindsey was not obligated to pay Dev-Land's commission (beyond the percentage of the down payment) until and unless Lindsey actually received buyers' installment payments. Thus, it is clear that Lindsey's liability to pay the commission expense in question arose, not at the time of sale, but as each installment became due. This is the only logical result to be reached, otherwise Lindsey would be able to deduct expenses he might never incur and thus avoid payment of taxes on his true taxable income. (See Hawekotte, Accrual and Unusual Punishment, 25 UCLA L. Rev. 70, 73-78 (1977), for a summary of the requirements of the "all events" test; see also, United States v. Anderson, 269 U.S. 422 [70 L. Ed. 347] (1926).)

We are not persuaded by the authorities cited by appellant that our conclusion should be different here. Appellants rely on the case of Ohmer Register Co. v. Commissioner, 131 F.2d 682 (6th Cir. 1942), to support Lindsey's deduction of the full commissions expense at once. But in Ohmer Register, the taxpayer had reported the sales income at the same time as it deducted the sales expense, and we believe this fact was critical to the court's reasoning, i.e., "[b]oth sides of the ledger must be treated alike." (Ohmer Register Co., supra, at 684; see also Air-Way Electric Appliance Corp. v. Guitteau, 123 F.2d 20 (6th Cir. 1941).) In the instant case, Dev-Land's commission income was definitely not reported simultaneously with Lindsey's deduction of commission expense, resulting in the sort of "divided transaction" which Ohmer Register rejected. (Ohmer Register Co., supra, at 684.)

Finally, we do not agree that Lindsey, as a dealer, was "required" to deduct the full commissions expense at the time of sale. Appellants apparently overlooked some of the language contained in a case cited by them, Solly K. Frankenstein, 31 T.C. 431 (1958), affd., 272 F.2d 135 (7th Cir. 1959), in which the taxpayer charged to the cost of sale, the expense of furnishing abstracts to land buyers at the time of final payment. In rejecting this approach the Tax Court stated:

> [R]espondent has consistently provided that "dealers" should deduct selling commissions and other sales expenses as ordinary business expenses in the year of accrual or payment, depending on the method of accounting, and that such expenses should not be spread over the period of the installment payments. [Citations.] (31 T.C. at 436.) (Emphasis added.)

In fact, the reasoning of Frankenstein rejects the deduction of sales costs which are merely estimated and not a definite liability.

We are convinced that appellants' accounting practices distorted their true income and therefore, pursuant to Cal. Admin. Code, tit. 18, reg. 17561, subd. (b) (1), respondent has properly exercised its authority to require an accounting method which is an accurate picture of Lindsey's and Dev-Land's respective incomes. The appellants have failed to show error in respondent's action and for that reason, we believe the proposed assessments of personal income tax against Lindsey must be upheld. We further find that the assessments against Dev-Land should be reversed; that being so, it is unnecessary to consider further Dev-Land's contentions concerning the fair market value of notes it received from Lindsey in payment of sales commissions.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of John D. and Lucile A. Lindsey to proposed assessments of additional personal income tax in the amounts of $2,893.96 and $12,387.10 against John D. Lindsey individually for the years 1966 and 1967, respectively, and to a proposed assessment of additional personal income tax in the amount of $24,387.10 against them jointly for the year 1968, be and the same is hereby sustained; and pursuant to section 25667 that the action of the Franchise Tax Board on the protest of Dev-Land, Inc., against proposed assessments of additional franchise tax in the amounts of $6,845.77, $7,623.31, and $5,154.08 for the income years ended July 31, 1966, July 31, 1967 and July 31, 1968, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 28th day of June, 1979, by the State Board of Equalization.

William M. Bennett, Chairman
Richard Nevins, Member
Geo. Reilly, Member
, Member
, Member

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JOHN D. AND LUCILE A. LINDSEY,)
AND DEV-LAND, INC.)

ORDER CORRECTING CLERICAL ERROR

It is hereby ordered that the date "7/31/67" be substituted for the date "7/31/77" and that the date "7/31/68" be substituted for the date "7/31/78" under the column "Income Years" on page 1 of the opinion and order issued by this board on June 28, 1979.

Done at Sacramento, California, this 14th day of November, 1979, by the State Board of Equalization.

William M. Bennett, Chairman

, Member

Ernest J. Dronenburg, Jr., Member

, Member

George R. Reilly, Member